

KONA GRILL INC
Form 10-Q
August 04, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE
ACT OF 1934**

For the quarterly period ended June 30, 2014

or

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE
ACT OF 1934**

For the transition period from _____ to _____

Commission File Number 001-34082

Kona Grill, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Delaware

(State or other jurisdiction of incorporation or organization)

20-0216690

(I.R.S. Employer Identification No.)

7150 East Camelback Road, Suite 333
Scottsdale, Arizona 85251
(480) 922-8100

(Address, including zip code, and telephone number, including area code, of principal executive offices)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

| | |
|-------------------------|---|
| Large accelerated filer | Accelerated filer |
| Non-accelerated filer | (Do not check if a smaller reporting company) Smaller reporting company |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of July 31, 2014, there were 10,961,315 shares of the registrant’s common stock outstanding.

KONA GRILL, INC.

TABLE OF CONTENTS

Page

PART I. FINANCIAL INFORMATION

| | | |
|---------|---|----|
| Item 1. | Financial Statements | |
| | Condensed Consolidated Balance Sheets as of June 30, 2014 (Unaudited) and December 31, 2013 | 2 |
| | Condensed Consolidated Statements of Comprehensive Income for the Three and Six Months Ended June 30, 2014 and 2013 (Unaudited) | 3 |
| | Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2014 and 2013 (Unaudited) | 4 |
| | Notes to Condensed Consolidated Financial Statements | 5 |
| Item 2. | Management’s Discussion and Analysis of Financial Condition and Results of Operations | 10 |
| Item 3. | Quantitative and Qualitative Disclosures About Market Risk | 21 |
| Item 4. | Controls and Procedures | 22 |

PART II. OTHER INFORMATION

| | | |
|----------|---|----|
| Item 1. | Legal Proceedings | 23 |
| Item 1A. | Risk Factors | 23 |
| Item 2. | Unregistered Sales of Equity Securities and Use of Proceeds | 23 |
| Item 3. | Defaults Upon Senior Securities | 24 |
| Item 4. | Mine Safety Disclosures | 24 |
| Item 5. | Other Information | 24 |
| Item 6. | Exhibits | 24 |

PART I – FINANCIAL INFORMATION**Item 1. Financial Statements****KONA GRILL, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(in thousands, except share data)**

| | June 30, 2014 (Unaudited) | December 31, 2013 (Note 1) |
|--|---|--|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 42,020 | \$ 5,881 |
| Short-term investments | 178 | 177 |
| Receivables | 604 | 845 |
| Other current assets | 1,639 | 1,499 |
| Total current assets | 44,441 | 8,402 |
| Other assets | 1,100 | 1,114 |
| Property and equipment, net | 44,589 | 40,352 |
| Total assets | \$ 90,130 | \$ 49,868 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 1,941 | \$ 2,726 |
| Accrued expenses | 8,014 | 8,652 |
| Current portion of debt obligations | — | 3,500 |
| Total current liabilities | 9,955 | 14,878 |
| Deferred rent | 15,184 | 12,632 |
| Total liabilities | 25,139 | 27,510 |
| Commitments and contingencies (Note 10) | | |
| Stockholders' equity: | | |
| Preferred stock, \$0.01 par value, 2,000,000 shares authorized, none issued | — | — |
| Common stock, \$0.01 par value, 15,000,000 shares authorized, 11,077,515 shares issued and 10,961,315 shares outstanding at June 30, 2014; 8,718,922 shares issued and 8,602,722 shares outstanding at December 31, 2013 | 111 | 87 |
| Additional paid-in capital | 95,422 | 54,083 |

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| | | |
|--|-----------|-----------|
| Accumulated deficit | (29,542) | (30,812) |
| Treasury stock, at cost, 116,200 shares at June 30, 2014 and December 31, 2013 | (1,000) | (1,000) |
| Total stockholders' equity | 64,991 | 22,358 |
| Total liabilities and stockholders' equity | \$ 90,130 | \$ 49,868 |

See accompanying notes to condensed consolidated financial statements.

KONA GRILL, INC.**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(in thousands, except per share data)****(unaudited)**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--|-------------|--------------------------------------|-------------|
| | 2014 | 2013 | 2014 | 2013 |
| Restaurant sales | \$29,886 | \$25,796 | \$57,502 | \$49,292 |
| Costs and expenses: | | | | |
| Cost of sales | 8,210 | 6,968 | 15,720 | 13,421 |
| Labor | 9,900 | 8,408 | 19,326 | 16,274 |
| Occupancy | 2,001 | 1,697 | 3,844 | 3,312 |
| Restaurant operating expenses | 4,023 | 3,401 | 7,871 | 6,572 |
| General and administrative | 2,443 | 2,010 | 5,019 | 3,885 |
| Preopening expense | 509 | 41 | 899 | 41 |
| Depreciation and amortization | 1,717 | 1,412 | 3,404 | 2,841 |
| Total costs and expenses | 28,803 | 23,937 | 56,083 | 46,346 |
| Income from operations | 1,083 | 1,859 | 1,419 | 2,946 |
| Write off of deferred financing costs | — | 66 | — | 66 |
| Interest expense, net | 64 | 41 | 124 | 44 |
| Income before income taxes | 1,019 | 1,752 | 1,295 | 2,836 |
| Provision for income taxes | — | 195 | 25 | 275 |
| Net income | \$1,019 | \$1,557 | \$1,270 | \$2,561 |
| Net income per share: | | | | |
| Basic | \$0.12 | \$0.18 | \$0.15 | \$0.30 |
| Diluted | \$0.11 | \$0.18 | \$0.14 | \$0.30 |
| Weighted average shares used in computation: | | | | |
| Basic | 8,770 | 8,567 | 8,690 | 8,555 |
| Diluted | 9,081 | 8,692 | 9,022 | 8,672 |
| Comprehensive income | \$1,019 | \$1,557 | \$1,270 | \$2,561 |

See accompanying notes to condensed consolidated financial statements.

KONA GRILL, INC.**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

| | Six Months Ended June 30, | |
|---|--------------------------------------|-------------|
| | 2014 | 2013 |
| Operating activities | | |
| Net income | \$1,270 | \$2,561 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 3,404 | 2,841 |
| Stock-based compensation | 418 | 288 |
| Excess income tax benefits from stock option exercises | — | (75) |
| Amortization of deferred financing costs | 53 | 26 |
| Write off of deferred financing costs | — | 66 |
| Change in operating assets and liabilities: | | |
| Receivables | 241 | 274 |
| Other current assets | (140) | (345) |
| Accounts payable | (493) | (126) |
| Accrued expenses | 759 | (466) |
| Deferred rent | 2,552 | (958) |
| Net cash provided by operating activities | 8,064 | 4,086 |
| Investing activities | | |
| Purchase of property and equipment | (9,536) | (1,262) |
| Change in other assets | (40) | 7 |
| | (9,576) | (1,255) |

Net cash used in
investing activities

Financing activities

| | | |
|---|----------|--------|
| Debt repayments | (3,500) | (370) |
| Fees paid for credit facility | — | (356) |
| Proceeds from issuance of common stock, net of issuance costs | 41,085 | — |
| Proceeds from issuance of common stock under the Employee Stock Purchase Plan and exercise of stock options | 66 | 196 |
| Excess income tax benefits from stock option exercises | — | 75 |
| Purchase and retirement of common stock | — | (203) |
| Net cash provided by (used in) financing activities | 37,651 | (658) |

| | | |
|--|----------|----------|
| Net increase in cash and cash equivalents | 36,139 | 2,173 |
| Cash and cash equivalents at the beginning of the period | 5,881 | 7,989 |
| Cash and cash equivalents at the end of the period | \$42,020 | \$10,162 |

Supplemental disclosure of cash flow information

| | | |
|---|-------|------|
| Cash paid for interest, net of capitalized interest | \$99 | \$6 |
| Cash paid for income taxes, net of refunds | \$110 | \$70 |

Noncash investing activities

| | | |
|--|---------|-------|
| | \$1,218 | \$397 |
|--|---------|-------|

Accounts payable and
accruals related to
property and
equipment

See accompanying notes to condensed consolidated financial statements.

4

KONA GRILL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. Basis of Presentation

Kona Grill, Inc., including its wholly-owned subsidiaries, (referred to herein as the “Company” or “we,” “us,” and “our”) develops, owns and operates upscale casual dining restaurants under the name “Kona Grill.” Our restaurants feature a diverse selection of American favorites and award-winning sushi that are prepared fresh daily. We own and operate 27 restaurants in 17 states throughout the United States. We operate as a single segment for reporting purposes.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the rules and regulations of the U.S. Securities and Exchange Commission (“SEC”). Accordingly, they do not include all of the information and notes required by U.S. generally accepted accounting principles for complete financial statements. In our opinion, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014.

The consolidated balance sheet at December 31, 2013 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and notes required by U.S. generally accepted accounting principles for complete financial statements. Accordingly, these financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2013.

The Company has evaluated subsequent events and transactions for potential recognition or disclosure in the financial statements through the day the financial statements are issued.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board amended the Accounting Standards Codification and created Topic 606, *Revenue from Contracts with Customers*, to clarify the principles for recognizing revenue. This guidance requires that an entity recognize revenue to depict the transfer of promised goods or services to customers at an

amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This guidance will be effective for the Company beginning January 1, 2017 and must be adopted using either a full retrospective approach for all periods presented in the period of adoption or a modified retrospective approach. We are currently assessing the method of adoption and the potential impact this guidance may have on our financial position, results of operations and cash flows.

2. Fair Value Measurements

Our short-term investments in certificates of deposit represent available-for-sale securities that are valued using market observable inputs.

The following tables present information about our assets measured at fair value on a recurring basis at June 30, 2014 and December 31, 2013, and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value (in thousands):

| June 30, 2014 | Level 1 | Level 2 | Level 3 | Total |
|-------------------------|--------------------|--------------------|--------------------|--------------|
| Certificates of deposit | \$ | —\$178 | \$ | — 178 |

| December 31, 2013 | Level 1 | Level 2 | Level 3 | Total |
|--------------------------|--------------------|--------------------|--------------------|--------------|
| Certificates of deposit | \$ | —\$177 | \$ | — 177 |

3. Net Income Per Share

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share includes the dilutive effect of potential stock option exercises, calculated using the treasury stock method.

The following table sets forth the computation of basic and diluted net income per share:

| | Three Months Ended June 30, 2014 | | Six Months Ended June 30, 2014 | |
|-----------------------------------|---|-------------|---|-------------|
| | 2013 | 2014 | 2013 | 2014 |
| | (In thousands, except per share data) | | | |
| Numerator: | | | | |
| Net income | \$1,019 | \$1,557 | \$1,270 | \$2,561 |
| Denominator: | | | | |
| Weighted average shares — Basic | 8,770 | 8,567 | 8,690 | 8,555 |
| Effect of dilutive stock options | 311 | 125 | 332 | 117 |
| Weighted average shares — Diluted | 9,081 | 8,692 | 9,022 | 8,672 |
| Net income per share: | | | | |
| Basic | \$0.12 | \$0.18 | \$0.15 | \$0.30 |
| Diluted | \$0.11 | \$0.18 | \$0.14 | \$0.30 |

Stock options outstanding that were not included in the dilutive earnings per share calculation because the effect would have been anti-dilutive were none and 183,000, respectively, for the three months ended June 30, 2014 and 2013, and 178,000 and 370,000, respectively, for the six months ended June 30, 2014 and 2013.

4. Property and Equipment

Property and equipment consisted of the following (in thousands):

**June 30, December
31,
2014**

| | 2013 | |
|--|-------------|-----------|
| Leasehold improvements | \$61,669 | \$ 55,810 |
| Equipment | 17,456 | 15,808 |
| Furniture and fixtures | 5,628 | 4,768 |
| | 84,753 | 76,386 |
| Less accumulated depreciation and amortization | (43,728) | (40,324) |
| | 41,025 | 36,062 |
| Construction in progress | 3,564 | 4,290 |
| Total property and equipment, net | \$44,589 | \$ 40,352 |

5. Accrued Expenses

Accrued expenses consisted of the following (in thousands):

| | June 30, 2014 | December 31, 2013 |
|---|------------------------------|----------------------------------|
| Accrued payroll and related liabilities | \$3,272 | \$ 2,557 |
| Accrued construction and remodel costs ⁽¹⁾ | 672 | 2,275 |
| Gift card liability | 1,230 | 1,586 |
| Accrued taxes | 1,484 | 1,235 |
| Occupancy related expenses | 164 | 264 |
| Other | 1,192 | 735 |
| | \$8,014 | \$ 8,652 |

(1) Balance is attributable to property additions for our new restaurants and remodels.

6. Debt and Credit Agreements

On April 19, 2013, we entered into a Credit Agreement for a \$20 million revolving line of credit (the “Credit Facility”) with KeyBank National Association (“KeyBank”) and Stearns Bank National Association (“Stearns Bank” collectively with Key Bank, the “Lenders”). The Credit Facility replaced the prior \$6.5 million credit line with Stearns Bank (the “Credit Line”). The Credit Facility is secured by our personal property and assets. Certain of our wholly owned subsidiaries have also guaranteed the Credit Facility.

The Credit Facility matures on April 19, 2017, with an option to extend the maturity date for one year subject to the Lenders’ consent. The interest rate on the Credit Facility is calculated at KeyBank’s prime rate or LIBOR, at our option, plus an applicable margin depending on our leverage ratio. The LIBOR margins range from 3.0% to 3.5% and the base rate margins range from 2.0% to 2.5%. Payments on the Credit Facility are interest only, payable quarterly with respect to each base rate loan and at varying times with respect to LIBOR rate loans, with outstanding principal and interest due at maturity. Prepayment is permitted at any time without penalty, subject to certain restrictions on the order of repayment or prepayment. We are obligated to pay a commitment fee, payable quarterly in arrears at an annual rate of 0.375% or 0.50% times the unused total revolving commitment of the Credit Facility, based on the average daily amount outstanding under the Credit Facility for the previous quarter. We recognized commitment fees of \$21,000 and \$41,000 in interest expense during the three and six months ended June 30, 2014.

During the fourth quarter of 2013, we borrowed \$3.5 million against the Credit Facility at the one-month LIBOR rate. The average borrowing rate for the six months ended June 30, 2014 was approximately 3.4%, including the LIBOR margin. On June 30, 2014, we paid off all outstanding borrowings under the Credit Facility with existing cash on hand.

The Credit Facility also requires us to comply with certain covenants, including (a) a minimum fixed charge coverage ratio of 1.25 through March 31, 2015 and 1.50 from April 1, 2015 through the maturity date, and (b) a maximum leverage ratio of 4:1. As of December 31, 2013, there was a technical event of default related to the matter described in Note 10 and accordingly, all borrowings under the Credit Facility were classified as a current liability at December 31, 2013. The default judgment was subsequently set aside on April 7, 2014, and we were in compliance with all covenants at June 30, 2014.

Prior to closing on the Credit Facility, we had loan agreements with Stearns Bank for a \$0.5 million Term Loan and a \$6.5 million Credit Line. We did not have any borrowings under the Stearns Bank Credit Line prior to its termination in April 2013. We utilized existing cash to pay off the outstanding balance on the Stearns Bank Term Loan on April 19, 2013 and wrote off \$66,000 in deferred financing costs related to the prior loan agreements during the second quarter of 2013.

Fees incurred for the KeyBank Credit Facility totaled \$356,000. Unamortized fees of \$295,000 at June 30, 2014 are amortized over the life of the Credit Facility and included in other assets in the consolidated balance sheet. Loan fee amortization during the three months ended June 30, 2014 and 2013 was \$26,000 and \$22,000, respectively, and \$53,000 and \$26,000 during the six months ended June 30, 2014 and 2013, respectively.

7. Income Taxes

During the six months ended June 30, 2014, we recorded a provision for income taxes of \$25,000, consisting of state tax expenses for which no state net operating losses and other credits exist. The provision for income taxes during the three and six months ended June 30, 2013 was \$195,000 and \$275,000, respectively, and consists of certain federal and state tax expenses for which no federal or state net operating losses or other credits exist.

At June 30, 2014, we had deferred tax assets primarily related to state net operating loss carryforwards and FICA tip credit carryforwards. We have a full valuation allowance for these carryforwards due to the uncertainty surrounding their future utilization. The realization of our deferred tax assets ultimately depends on the existence of sufficient taxable income in the appropriate taxing jurisdictions in future periods. We have analyzed, and will continue to analyze, the positive and negative evidence to support our conclusion regarding the appropriate amount of our valuation allowance. The valuation allowance could be reduced in a subsequent period if there is sufficient evidence to support a conclusion that it is more likely than not that the state net operating loss carryforwards and/or the FICA tip credit carryforwards will be realized. Future changes in our valuation allowance could have a material effect on our results of operations in the period recorded.

8. Stock-Based Compensation

The fair value of stock options granted during the six months ended June 30, 2014 and 2013 was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

| | Six Months Ended June 30, | |
|--|--|-------------|
| | 2014 | 2013 |
| Expected volatility | 36.9% | 38.9% |
| Risk-free interest rate | 0.7 % | 0.6 % |
| Expected option life (in years) | 2.9 | 3.4 |
| Dividend yield | 0.0 % | 0.0 % |
| Weighted average fair value per option granted | \$4.13 | \$2.49 |

The following table summarizes our stock option activity for the six months ended June 30, 2014:

| | Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value |
|--|----------------|--|---|--|
| Outstanding options at December 31, 2013 | 783,297 | \$ 6.94 | | |
| Granted | 295,900 | 16.12 | | |
| Forfeited | (3,500) | 14.89 | | |
| Exercised | (12,572) | 3.71 | | |
| Outstanding options at June 30, 2014 | 1,063,125 | \$ 9.50 | 3.2 | \$10,532,000 |
| Exercisable at June 30, 2014 | 461,325 | \$ 6.86 | 2.6 | \$5,789,000 |

We recognized stock-based compensation expense of \$217,000 and \$146,000 during the three months ended June 30, 2014 and 2013, respectively, and \$418,000 and \$288,000 during the six months ended June 30, 2014 and 2013, respectively. As of June 30, 2014, there was \$1,559,000 of unrecognized stock-based compensation expense related to unvested stock-based compensation awards, which is expected to be recognized over a weighted average period of 2.5 years.

The total shares of common stock reserved for issuance totaled 2,200,000, of which 289,525 shares were available for grant as of June 30, 2014.

9. Common Stock

Stock Purchase and Retirement Program

In May 2012, our Board of Directors authorized a stock repurchase and retirement program of up to \$5,000,000 of our outstanding common stock. The authorization of the program does not have an expiration date and it does not require us to purchase a specific dollar amount of shares. This authorization may be modified, suspended or terminated at any time. The timing and number of shares purchased pursuant to the share purchase authorization are subject to a number of factors, including current market conditions, legal constraints and available cash.

As of June 30, 2014, we have spent \$3.2 million to purchase and retire 387,109 shares under the 2012 authorization. We did not repurchase any shares during the six months ended June 30, 2014 and purchased \$203,000 of stock during the six months ended June 30, 2013.

Common Stock Offering

On June 25, 2014, we completed a public offering of 2,645,000 shares of our common stock at an offering price of \$18.50 per share. We sold an aggregate of 2,345,000 shares, of which 345,000 shares were sold pursuant to the underwriters' exercise of their option to purchase additional shares. The remaining 300,000 shares were sold by certain selling stockholders. The aggregate net proceeds received for the offering totaled \$40.9 million, reflecting gross proceeds of \$43.4 million, less underwriting expenses of \$2.2 million and other offering costs of \$0.3 million. Net proceeds from the offering will be used for new unit expansion, capital expenditures and general corporate purposes.

10. Commitments and Contingencies

We are engaged in various legal actions, which arise in the ordinary course of our business. Although there can be no assurance as to the ultimate disposition of these matters, it is the opinion of our management, based upon the information available at this time, that the expected outcome of these matters, individually or in the aggregate, will not have a material adverse effect on the results of operations or financial condition of the company.

On February 10, 2014, Kona Grill Macadamia, Inc., a wholly-owned subsidiary of the Company ("Macadamia"), filed a Motion to Set Aside Default Judgment in the Circuit Court of Jackson County, Kansas City Missouri relating to a default judgment of approximately \$3.5 million entered into on December 18, 2013 against Macadamia. The underlying personal injury claim, *Frank Neal Goss v. Kona Macadamia, Inc. and Anthony Deangelo*, revolves around a fight that two alleged restaurant patrons had outside of the Company's Kansas City restaurant on March 1, 2011, which is claimed to have resulted in physical injury to the plaintiff.

Following the hearing held on April 3, 2014, the Circuit Court issued a written order on April 7, 2014 granting Macadamia's Motion to Set Aside Default Judgment. The underlying personal injury case is proceeding in the Circuit Court, and on April 16, 2014, Macadamia filed its answer to the plaintiff's complaint. We believe that we have a strong defense to the claim asserted by the plaintiff and insurance coverage for the claim.

Item 2. *Management's Discussion and Analysis of Financial Condition and Results of Operations*

The following discussion and analysis should be read in conjunction with the unaudited condensed consolidated financial statements and notes thereto included in Item 1 of Part I of this Form 10-Q and the audited consolidated financial statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations for the year ended December 31, 2013 contained in our 2013 Annual Report on Form 10-K.

Certain information included in this discussion contains forward-looking statements that involve known and unknown risks and uncertainties, such as statements relating to our future economic performance, plans and objectives for future operations, expectations, intentions and other financial items that are based on our beliefs as well as assumptions made by and information currently available to us. Factors that could cause actual events or results to differ materially from those indicated by these forward-looking statements may include the matters under Item 1A, "Risk Factors" in this report, our Annual Report on Form 10-K for the year ended December 31, 2013 and other reports filed from time to time with the SEC.

Overview

We currently own and operate 27 restaurants located in 17 states. We offer freshly prepared food, attentive service, and a contemporary ambiance that create a satisfying yet affordable dining experience that we believe exceeds many traditional casual dining restaurants with which we compete. Our high-volume polished casual restaurants feature a diverse selection of flavorful American favorites with an international influence and award-winning sushi items. Our menu items are freshly prepared and incorporate over 40 signature sauces and dressings that we make from scratch at each restaurant location, creating broad-based appeal for the lifestyle and taste trends of a diverse group of customers. We believe that our diverse menu and generous portions, combined with an average check of approximately \$25 per person, offers our customers an attractive price-value proposition.

The restaurant industry is significantly affected by changes in economic conditions, discretionary spending patterns, consumer confidence, and other factors. Our same-store sales increased 3.2% in the second quarter of 2014 compared to a 2.5% same-store sales increase in the prior year same quarter. The increase in comparable restaurant sales during the quarter is primarily due to a 3.6% increase in customer traffic driven in part by the remodels in the fourth quarter of 2013 and the strength and popularity of our concept. We believe consumer sentiment continues to remain cautious amid continuing macroeconomic uncertainties as many segments within the restaurant industry reported negative same-store sales and overall traffic declines throughout 2013 and the first half of 2014. We expect the restaurant industry will continue to face a sluggish sales environment in the short term as the slow improvements in the labor market continue to put pressure on disposal income for restaurant spending. We also believe improvement in consumer confidence and spending in general, will be important and necessary catalysts to drive customer traffic and higher customer check averages in casual dining restaurants in general and our restaurants in particular.

We continue to focus on growing sales while remaining disciplined with our costs. The average unit volume of our comparable base restaurants was \$1.2 million, or \$164 per square foot in the second quarter of 2014 compared to \$1.1 million, or \$159 per square foot in the second quarter of 2013. Our average unit volume grew 3.2% year over year despite continuing cautious consumer spending and a highly competitive industry landscape. Our restaurant operating profit, defined as restaurant sales minus cost of sales, labor, occupancy, and restaurant operating expenses, was \$5.8 million, or 19.2% as a percentage of restaurant sales in the second quarter of 2014 and includes operating inefficiencies of four new restaurants that opened in the past three quarters. Restaurant operating profit in the prior year same quarter was \$5.3 million, or 20.6% as a percentage of sales. Our Adjusted EBITDA, defined as income from operations plus depreciation and amortization, preopening expense and stock-based compensation, increased 2.0% to \$3.5 million, or 11.8% as a percentage of restaurant sales in the second quarter of 2014 compared to \$3.5 million, or 13.4% as a percentage of restaurant sales in the second quarter of 2013. See “Key Measures” and “Financial Performance Overview” below for further information on restaurant operating profit and Adjusted EBITDA, including a reconciliation to our income from operations.

We experience various patterns in our operating cost structure. Cost of sales, labor, and other operating expenses for our restaurants open at least 12 months generally trend consistently with restaurant sales, and we analyze those costs as a percentage of restaurant sales. Our typical new restaurants experience gradually increasing unit volumes as customers discover our concept and we generate market awareness. We anticipate that our new restaurants will take approximately six to twelve months to achieve operating efficiencies as a result of challenges typically associated with opening and operating new restaurants, including lack of market recognition and the need to hire and sufficiently train employees, as well as other factors. We expect cost of sales and labor expenses as a percentage of restaurant sales to be higher when we open a new restaurant, but to decrease as a percentage of restaurant sales as the restaurant matures and as the restaurant management and employees become more efficient in operating that unit. Occupancy and a portion of restaurant operating expenses are fixed. As a result, the volume and timing of newly opened restaurants has had, and is expected to continue to have, an impact on cost of sales, labor, occupancy, and restaurant operating expenses measured as a percentage of restaurant sales.

The majority of our general and administrative costs are fixed costs. Over the longer term, we expect our general and administrative spending to generally decrease as a percentage of restaurant sales as we leverage these investments and realize the benefits of higher sales volumes. We expect our general and administrative costs for 2014 to increase as we make additional investments in development and operations personnel and infrastructure to accelerate new unit growth. The increase in 2014 also reflects our estimate of higher stock-based compensation expense and higher professional fees associated with being required to comply with the auditor attestation requirements of Section 404 of the Sarbanes-Oxley Act resulting from our higher market capitalization.

Our goal is to grow organically through unit expansion, with a goal of 20% unit growth annually over the next several years. We plan to open five new restaurants in 2014, including the Fort Worth location that opened on February 6, 2014 and the El Paso location that opened on June 23, 2014. We have commenced the construction of the three remaining locations and plan to open these restaurants during the fourth quarter of 2014. This equates to a unit growth rate of 20% for 2014. We currently have four additional signed leases for new restaurant openings and continue to work diligently to build a strong pipeline to achieve our growth objectives.

We incurred preopening expense of \$0.9 million during the first half of 2014, attributable to the Fort Worth and El Paso openings and in preparation for the opening of additional locations during the fourth quarter of 2014. Although the actual preopening expenses for a particular location depend upon numerous factors, we expect cash preopening expenses of approximately \$400,000 per location, and non-cash preopening rent expense ranging from \$50,000 to \$100,000 per location. We expect to incur additional preopening expense in 2014 as unit expansion efforts accelerate. Accordingly, we expect the opening of new units to place downward pressure on our profitability as significant preopening expenses are incurred while operating profit from the new restaurants will likely not be significant in the first few months of each new restaurant's operation as a result of challenges typically associated with opening new restaurants.

On June 25, 2014, we completed a public offering of 2.6 million shares of our common stock at an offering price of \$18.50 per share. We sold an aggregate of 2.3 million shares and the remaining 0.3 million shares were sold by certain

selling stockholders. Net proceeds from this offering were \$40.9 million and will be used for new unit expansion, capital expenditures and general corporate purposes.

On June 30, 2014, we paid off the \$3.5 million outstanding borrowings under our credit facility with existing cash on hand. Our entire \$20 million credit facility is available as of June 30, 2014.

Key Measures

Key measures we use to evaluate and assess our business include the following:

Number of Restaurant Openings. Number of restaurant openings reflects the number of restaurants opened during a particular reporting period.

Same-Store Sales Percentage Change. Same-store sales percentage change reflects the periodic change in restaurant sales for the comparable restaurant base. In calculating the percentage change in same-store sales, we include a restaurant in the comparable restaurant base after it has been in operation for more than 18 months. We adjust the sales included in the same-store sales calculation for restaurant closures, primarily as a result of remodels, so that the periods will be comparable. Same-store sales growth can be generated by an increase in customer traffic counts or by increases in the per person average check amount. Menu price changes and the mix of menu items sold can affect the per person average check amount.

Average Weekly Sales. Average weekly sales represent the average of restaurant sales for the comparable or non-comparable restaurant base measured over consecutive Monday through Sunday time periods.

Average Unit Volume. Average unit volume represents the average restaurant sales for the comparable restaurant base.

Sales Per Square Foot. Sales per square foot represent the restaurant sales for our comparable restaurant base, divided by the total leasable square feet for such restaurants.

Restaurant Operating Profit. Restaurant operating profit is defined as restaurant sales minus cost of sales, labor, occupancy, and restaurant operating expenses. Restaurant operating profit does not include general and administrative expenses, depreciation and amortization, or preopening expenses. We believe restaurant operating profit is an important component of financial results because it is a widely used metric within the restaurant industry to evaluate restaurant-level productivity, efficiency, and performance prior to application of corporate overhead. We use restaurant operating profit as a percentage of restaurant sales as a key metric to evaluate our restaurants' financial performance compared with our competitors. This measure provides useful information regarding our financial condition and results of operations and allows investors to better determine future financial results driven by growth and to compare restaurant level profitability.

Adjusted EBITDA. Adjusted EBITDA is defined as income from operations plus depreciation and amortization, preopening expense and stock-based compensation. Adjusted EBITDA is presented because: (i) we believe it is a useful measure for investors to assess the operating performance of our business without the effect of non-cash items such as depreciation and amortization expenses and stock-based compensation as well as the costs of opening new restaurants; (ii) we believe that investors will find these measures useful in assessing our ability to service or incur indebtedness; and (iii) we use Adjusted EBITDA internally as a benchmark to evaluate our operating performance and compare our performance to that of our competitors.

Key Financial Definitions

Restaurant Sales. Restaurant sales include gross food and beverage sales, net of promotions and discounts.

Cost of Sales. Cost of sales consists of food and beverage costs and related delivery fees.

Labor. Labor includes all direct and indirect labor costs incurred in operations.

Occupancy. Occupancy includes all rent payments associated with the leasing of real estate, including base, percentage and straight-line rent, property taxes, and common area maintenance expense. We record tenant improvement allowances as a reduction of occupancy expense over the term of the lease.

Restaurant Operating Expenses. Restaurant operating expenses consist of all other restaurant-level operating costs, the major components of which are utilities, credit card fees, advertising, supplies, marketing, repair and maintenance, and other expenses. Other operating expenses contain both variable and fixed components.

General and Administrative. General and administrative includes all corporate and administrative functions that support operations and provide infrastructure to facilitate our future growth. Components of this category include management and staff salaries, bonuses, stock-based compensation and related employee benefits, travel, information systems, human resources, training, corporate rent, professional and consulting fees, and corporate insurance costs.

Preopening Expense. Preopening expense consists of costs incurred prior to opening a new restaurant and is comprised principally of manager salaries and relocation, payroll and related training costs for new employees, including food and beverage costs associated with practice and rehearsal of service activities, and rent expense incurred from the date we obtain possession of the property until opening. We expense restaurant preopening expenses as incurred. We expect preopening expenses to commence six to eight months prior to a restaurant opening. Although the actual preopening expenses for a particular location depend upon numerous factors, our historical cash preopening expenses average approximately \$400,000 per location, and non-cash preopening rent expense typically ranges from \$50,000 to \$100,000 per location. Our preopening costs will fluctuate from period to period depending upon the number of restaurants opened, the timing of new restaurant openings, the location of the restaurants, and the complexity of the staff hiring and training process.

Depreciation and Amortization. Depreciation and amortization expense consists of the depreciation of property and equipment. Depreciation and amortization expense also includes gains or losses on the disposal of fixed assets, primarily associated with remodel activities.

Interest Expense, net. Interest expense consists of the cost of servicing our debt obligations, the amortization of debt issuance costs and commitment fees on the line of credit. Interest expense is offset by interest earned on investment balances. We capitalize interest incurred on borrowings for restaurant construction.

Provision for Income Taxes. Provision for income taxes reflects management's best estimate of its effective tax rate expected to be applicable for the full fiscal year. This estimate will be re-evaluated by management each quarter based on the Company's estimated income tax expense for the year.

Financial Performance Overview

The following table sets forth certain information regarding our financial performance for the three and six months ended June 30, 2014 and 2013. There were 23 restaurants in the comparable restaurant base as of June 30, 2014 and 2013. There were 4 restaurants in the non-comparable base as of June 30, 2014.

| | Three Months | | Six Months Ended | | | |
|---|----------------|----------|------------------|----------|---|---|
| | Ended June 30, | | June 30, | | | |
| | 2014 | 2013 | 2014 | 2013 | | |
| Restaurant sales growth | 15.9 | 3.2 | 16.7 | 0.3 | % | % |
| Same-store sales percentage change ⁽¹⁾ | 3.2 | 2.5 | 4.6 | (0.1) | % | % |
| Average weekly sales – comparable restaurant base | \$89,300 | \$86,500 | \$87,000 | \$83,200 | | |
| Average weekly sales – non-comparable restaurant base | \$81,900 | \$— | \$80,900 | \$— | | |

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| | | | | |
|---|---------|---------|----------|---------|
| Average unit volume (in thousands) ⁽²⁾ | \$1,160 | \$1,125 | \$2,250 | \$2,151 |
| Sales per square foot ⁽²⁾ | \$164 | \$159 | \$319 | \$305 |
| Restaurant operating profit (in thousands) ⁽³⁾ | \$5,752 | \$5,322 | \$10,741 | \$9,713 |
| Restaurant operating profit as a percentage of sales ⁽³⁾ | 19.2 % | 20.6 % | 18.7 % | 19.7 % |
| Adjusted EBITDA (in thousands) ⁽⁴⁾ | \$3,526 | \$3,458 | \$6,140 | \$6,116 |
| Adjusted EBITDA as a percentage of sales ⁽⁴⁾ | 11.8 % | 13.4 % | 10.7 % | 12.4 % |

Same-store sales percentage change reflects the periodic change in restaurant sales for the comparable restaurant base compared to the prior year. In calculating the percentage change for same-store sales, we include a restaurant ⁽¹⁾ in the comparable restaurant base after it has been in operation for more than 18 months. We remove restaurants from the comparable base for periods in which they are closed, primarily related to remodel activities.

(2) Includes only those restaurants in the comparable restaurant base.

Restaurant operating profit is not a financial measurement determined in accordance with U.S. generally accepted accounting principles (see reconciliation below) and should not be considered in isolation or as an alternative to income from operations. Restaurant operating profit may not be comparable to the same or similarly titled

(3) measures computed by other companies. We believe restaurant operating profit is an important component of financial results because it is a widely used metric within the restaurant industry to evaluate restaurant-level productivity, efficiency, and performance. We use restaurant operating profit as a percentage of restaurant sales as a key metric to evaluate our restaurants' financial performance compared with our competitors.

Adjusted EBITDA is not a financial measure determined in accordance with U.S. generally accepted accounting principles (see reconciliation below) and should not be considered in isolation or as an alternative to income from operations. Adjusted EBITDA is defined as income from operations plus depreciation and amortization, preopening expense and stock-based compensation. Adjusted EBITDA is presented because: (i) we believe it is a

(4) useful measure for investors to assess the operating performance of our business without the effect of non-cash items such as depreciation and amortization expenses and stock-based compensation as well as the costs of opening new restaurants; (ii) we believe that investors will find these measures useful in assessing our ability to service or incur indebtedness; and (iii) we use Adjusted EBITDA internally as a benchmark to evaluate our operating performance and compare our performance to that of our competitors.

The following tables set forth our reconciliation of Adjusted EBITDA and restaurant operating profit to our income from operations, the most comparable U.S. GAAP measure.

| | Three Months | | Six Months | |
|-------------------------------|-----------------------|-------------|-----------------------|-------------|
| | Ended June 30, | | Ended June 30, | |
| | 2014 | 2013 | 2014 | 2013 |
| | (In thousands) | | | |
| Income from operations | \$1,083 | \$1,859 | \$1,419 | \$2,946 |
| Depreciation and amortization | 1,717 | 1,412 | 3,404 | 2,841 |
| Preopening expense | 509 | 41 | 899 | 41 |
| Stock-based compensation | 217 | 146 | 418 | 288 |
| Adjusted EBITDA | \$3,526 | \$3,458 | \$6,140 | \$6,116 |
| General and administrative | 2,443 | 2,010 | 5,019 | 3,885 |
| Stock-based compensation | (217) | (146) | (418) | (288) |
| Restaurant operating profit | \$5,752 | \$5,322 | \$10,741 | \$9,713 |

| Percentage of Restaurant Sales Three Months | Percentage of Restaurant Sales Six Months Ended June |
|--|---|
|--|---|

| | Ended June 30, | | 30, | |
|-------------------------------|-----------------------|-------------|-------------|-------------|
| | 2014 | 2013 | 2014 | 2013 |
| Income from operations | 3.6 % | 7.2 % | 2.5 % | 6.0 % |
| Depreciation and amortization | 5.7 | 5.5 | 5.8 | 5.8 |
| Preopening expense | 1.7 | 0.2 | 1.6 | 0.1 |
| Stock-based compensation | 0.7 | 0.6 | 0.7 | 0.6 |
| Adjusted EBITDA | 11.8 | 13.4 | 10.7 | 12.4 |
| General and administrative | 8.2 | 7.8 | 8.8 | 7.9 |
| Stock-based compensation | (0.7) | (0.6) | (0.7) | (0.6) |
| Restaurant operating profit | 19.2 % | 20.6 % | 18.7 % | 19.7 % |

Certain amounts may not sum due to rounding.

Results of Operations

The following tables set forth, for the periods indicated, certain items from our financial statements and the percentage of restaurant sales for those items:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---------------------------------------|--|-------------|--------------------------------------|-------------|
| | 2014 | 2013 | 2014 | 2013 |
| | (In thousands) | | | |
| Restaurant sales | \$29,886 | \$25,796 | \$57,502 | \$49,292 |
| Costs and expenses: | | | | |
| Cost of sales | 8,210 | 6,968 | 15,720 | 13,421 |
| Labor | 9,900 | 8,408 | 19,326 | 16,274 |
| Occupancy | 2,001 | 1,697 | 3,844 | 3,312 |
| Restaurant operating expenses | 4,023 | 3,401 | 7,871 | 6,572 |
| General and administrative | 2,443 | 2,010 | 5,019 | 3,885 |
| Preopening expense | 509 | 41 | 899 | 41 |
| Depreciation and amortization | 1,717 | 1,412 | 3,404 | 2,841 |
| Total costs and expenses | 28,803 | 23,937 | 56,083 | 46,346 |
| Income from operations | 1,083 | 1,859 | 1,419 | 2,946 |
| Write off of deferred financing costs | — | 66 | — | 66 |
| Interest expense, net | 64 | 41 | 124 | 44 |
| Income before income taxes | 1,019 | 1,752 | 1,295 | 2,836 |
| Provision for income taxes | — | 195 | 25 | 275 |
| Net income | \$1,019 | \$1,557 | \$1,270 | \$2,561 |

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|-------------------------------|--|-------------|--------------------------------------|-------------|
| | 2014 | 2013 | 2014 | 2013 |
| Restaurant sales | 100.0% | 100.0% | 100.0% | 100.0% |
| Costs and expenses: | | | | |
| Cost of sales | 27.5 | 27.0 | 27.3 | 27.2 |
| Labor | 33.1 | 32.6 | 33.6 | 33.0 |
| Occupancy | 6.7 | 6.6 | 6.7 | 6.7 |
| Restaurant operating expenses | 13.5 | 13.2 | 13.7 | 13.3 |
| General and administrative | 8.2 | 7.8 | 8.7 | 7.9 |
| Preopening expense | 1.7 | 0.2 | 1.6 | 0.1 |
| Depreciation and amortization | 5.7 | 5.5 | 5.9 | 5.8 |
| Total costs and expenses | 96.4 | 92.8 | 97.5 | 94.0 |

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| | | | | |
|---------------------------------------|-----|-------|-------|-------|
| Income from operations | 3.6 | 7.2 | 2.5 | 6.0 |
| Write off of deferred financing costs | 0.0 | 0.3 | 0.0 | 0.1 |
| Interest expense, net | 0.2 | 0.2 | 0.2 | 0.1 |
| Income before income taxes | 3.4 | 6.8 | 2.3 | 5.8 |
| Provision for income taxes | 0.0 | 0.8 | 0.0 | 0.6 |
| Net income | 3.4 | % 6.0 | % 2.2 | % 5.2 |

Certain amounts may not sum due to rounding.

Three Months Ended June 30, 2014 Compared with Three Months Ended June 30, 2013

Restaurant Sales. Restaurant sales increased \$4.1 million, or 15.9% to \$29.9 million during the second quarter of 2014 from \$25.8 million in the second quarter of 2013. Sales from our four recently opened restaurants, including Boise, The Woodlands, Fort Worth and El Paso, contributed \$3.3 million to the total increase. Despite the continued tepid consumer spending and an increasingly competitive environment, our same store sales increased 3.2% year over year, primarily due to a 3.6% increase in customer traffic driven in part by the remodels in the fourth quarter of 2013 and the strength and popularity of our concept. The increase in customer traffic during the second quarter was partially offset by a slight decrease in average check per person year over year.

Cost of Sales. Cost of sales increased to \$8.2 million, or 17.8%, in the second quarter of 2014 compared to \$7.0 million in the prior year period. Of the total \$1.2 million increase year over year, \$1.0 million was attributable to our recently opened locations. Cost of sales as a percentage of restaurant sales increased 0.5% to 27.5% from 27.0% as we experienced inflationary pressure from seafood, meat, dairy and produce during the quarter and reflected in part, inefficiencies associated with the new locations.

Labor. Labor costs were \$9.9 million and \$8.4 million in the second quarter of 2014 and 2013, respectively. Labor expenses as a percentage of restaurant sales increased to 33.1% from 32.6% in the same prior year period. The year over year increase as a percentage of sales was due to labor costs associated with our restaurants, including inherent labor inefficiencies. We expect labor cost as a percentage of sales to trend higher than prior year until new restaurant management and employees become more efficient in operating their restaurants.

Occupancy. Occupancy expenses increased \$0.3 million, or 17.9% year over year to \$2.0 million. The higher occupancy expenses are primarily associated with base rent and common area maintenance charges associated with the new locations coupled with the lower benefit of tenant allowance amortization at certain restaurant locations as lease options were exercised or certain lease provisions had lapsed. Occupancy expenses as a percentage of restaurant sales increased 0.1% to 6.7% compared to 6.6% during the second quarter of 2013.

Restaurant Operating Expenses. Restaurant operating expenses increased \$0.6 million, or 18.3%, to \$4.0 million during the second quarter of 2014. Restaurant operating expenses as a percentage of restaurant sales increased 0.3% year over year to 13.5%, driven in part by operating inefficiencies associated with our new locations. Higher utilities, smallwares, professional services and personal property tax and insurance contributed to the remaining year over year increase.

General and Administrative. General and administrative expenses were \$2.4 million and \$2.0 million in the second quarter of 2014 and 2013, respectively. General and administrative expenses increased as a percentage of sales by

0.4% to 8.2% in the second quarter of 2014. The increase in general and administrative expenses in absolute dollars and as a percentage of sales is primarily attributable to headcount additions to support our growth initiatives, higher stock-based compensation expense resulting from our stock price appreciation, increased travel and legal costs related to development activities and higher audit and professional fees associated with SOX compliance requirements. The increase was partially offset by lower meeting expenses due to a timing shift for our annual general manager and executive chef conference.

Preopening Expense. Preopening expense of \$0.5 million in the second quarter of 2014 was primarily attributable to the El Paso restaurant which opened on June 23, 2014. We did not open any new restaurants in the second quarter of 2013.

Depreciation and Amortization. Depreciation and amortization expense was \$1.7 million and \$1.4 million in the second quarter of 2014 and 2013, respectively. As a percentage of restaurant sales, depreciation and amortization expense increased to 5.7% from 5.5% year over year. The increase is primarily attributable to depreciation expense for our new locations.

Interest Expense, net. Interest expense during the second quarter of 2014 includes loan fee amortization expense associated with our credit facility arrangements, interest costs incurred on credit facility borrowings, and line of credit commitment fees. Interest expense in the second quarter of 2013 also consists of interest incurred on the term loan, which was paid off in April 2013.

Write off of Deferred Financing Costs. In April 2013, we entered into a \$20 million credit facility with KeyBank and Stearns Bank. We paid off the outstanding term loan balance with cash on hand and terminated the existing \$6.5 million credit facility. In conjunction with this transaction, we wrote off \$66,000 in deferred loan fees related to the prior loan agreements in the second quarter of 2013.

Provision for Income Taxes. We did not recognize any income tax expense during the second quarter of 2014 due to projected net operating loss carryforwards expected to be generated from tax planning strategies and available credits to offset taxable income. We recorded a provision for income taxes of \$195,000 during the second quarter of 2013. The income tax provision for the three months ended June 30, 2013 consisted of certain federal and state tax expenses for which no net operating loss carryforwards or other credits exist.

Six Months Ended June 30, 2014 Compared with Six Months Ended June 30, 2013

Restaurant Sales. Restaurant sales increased 16.7% to \$57.5 million during the first half of 2014 from \$49.3 million in the first half of 2013. Of the \$8.2 million increase year over year, \$6.0 million was attributable to the four new restaurants opened since the fourth quarter of 2013. The remaining increase was driven by comparable sales growth of 4.6% resulting mainly from higher guest traffic in the first half of 2014.

Cost of Sales. Cost of sales increased \$2.3 million, or 17.1% to \$15.7 million during the first half of 2014 compared to \$13.4 million during the same period in the prior year. New locations opened since the fourth quarter of 2013 accounted for \$1.8 million of the total increase. As a percentage of restaurant sales, cost of sales was 27.3% compared to 27.2% during the same prior year period. The increase was driven by inefficiencies in our new restaurants, partially offset by a slight decrease in the current period for restaurants in our comparable base.

Labor. Labor costs in the first half of 2014 grew 18.8% to \$19.3 million compared to \$16.3 million in the comparable prior year period. Labor costs for new locations accounted for \$2.4 million of the total \$3.0 million increase. Labor expenses as a percentage of restaurant sales were 33.6% compared to 33.0% in the first half of 2013, reflecting labor inefficiencies associated with new openings.

Occupancy. Occupancy expenses increased \$0.5 million, or 16.1% to \$3.8 million in 2014 year to date from \$3.3 million during the first half of 2013. The higher occupancy expenses are primarily associated with base rent and common area maintenance charges associated with the new locations coupled with the lower benefit of tenant allowance amortization mainly at one restaurant location as lease provisions lapsed. Occupancy expenses as a percentage of restaurant sales were 6.7% in year to date 2014 and 2013.

Restaurant Operating Expenses. Restaurant operating expenses increased \$1.3 million, or 19.8%, to \$7.9 million during the first half of 2014 compared to \$6.6 million in the same period in 2013. Of the total increase, \$0.8 million resulted from the additional operating expenses associated with our new locations. Restaurant operating expenses as a percentage of restaurant sales were 13.7% during the first half of 2014 compared to 13.3% in the first half of 2013. Higher utilities, smallwares, professional services and personal property tax and insurance primarily contributed to the remaining year over year increase.

General and Administrative. General and administrative expenses increased by \$1.1 million, or 29.2% to \$5.0 million from \$3.9 million year over year. General and administrative expenses increased as a percentage of sales by 0.8% to 8.7% in the first half of 2014 compared to 7.9% in the first half of 2013. The increase in general and administrative expenses in absolute dollars and as a percentage of sales is primarily attributable to headcount additions to support our growth initiatives, higher stock-based compensation expense resulting from our stock price appreciation, increased travel costs related to development activities, higher legal and audit fees and higher costs incurred for our annual general manager and executive chef conference.

Preopening Expense. Preopening expense was \$0.9 million in the first half of 2014 compared to minimal expense in the first half of 2013. The year over year increase was primarily attributable to the Fort Worth and El Paso locations which opened in February and June of 2014, respectively. We did not open any new restaurants in the first half of 2013.

Depreciation and Amortization. Depreciation and amortization expense increased 19.8% to \$3.4 million in 2014 year to date from \$2.8 million in the prior year. Depreciation and amortization expense as a percentage of restaurant sales increased to 5.9% during the first half of 2014 from 5.8% during the prior year period. The increase was due to depreciation for new and remodeled restaurants, partially offset by the impact of fully depreciated assets at certain locations.

Write off of Deferred Financing Costs. In April 2013, we entered into a \$20 million credit facility with KeyBank and Stearns Bank. We paid off the outstanding term loan balance with cash on hand and terminated the existing \$6.5 million credit facility. In conjunction with this transaction, we wrote off \$66,000 in deferred loan fees related to the prior loan agreements in the second quarter of 2013.

Interest Expense. Interest expense increased in the second half of 2014 as compared to the prior year period. The increase resulted from to the amortization of deferred loan fees and the commitment fees associated with the KeyBank credit facility obtained in April 2013.

Provision for Income Taxes. We recorded a provision for income taxes of \$25,000 and \$275,000 in 2014 and 2013 year to date, respectively. The provision for income taxes during the first half of 2014 consists of state tax expenses for which no state net operating losses and other credits exist and reflects the projected net operating loss carryforwards expected to be generated from tax planning strategies. The provision for income taxes during the first half of 2013 is attributable to federal and certain state tax expenses for which no federal or state net operating losses or other credits exist.

Potential Fluctuations in Quarterly Results and Seasonality

Our quarterly operating results may fluctuate significantly as a result of a variety of factors, including the following:

- timing of new restaurant openings and related expenses;
- fluctuations in commodity and food protein prices;

preopening costs for our newly-opened restaurants and operating costs for those locations, which are often materially greater during the first several months of operation than thereafter;
timing of restaurant remodels and potential lost sales associated with remodel closure;
labor availability and costs for hourly and management personnel;
profitability of our restaurants, especially in new markets;
increases and decreases in comparable restaurant sales;
impairment of long-lived assets and any loss on restaurant closures;
changes in borrowings and interest rates;
general economic conditions;
weather conditions or natural disasters;
timing of certain holidays;
changes in government regulations;
settlements, damages and legal costs associated with litigation;
new or revised regulatory requirements and accounting pronouncements; and
changes in consumer preferences and competitive conditions.

Our business is also subject to seasonal fluctuations. Historically, sales in most of our restaurants have been higher during the spring and summer months and winter holiday season. Consequently, our quarterly and annual operating results and comparable restaurant sales may fluctuate significantly as a result of seasonality and the factors discussed above. Accordingly, results for any one quarter are not necessarily indicative of results to be expected for any other quarter or for any year and comparable restaurant sales for any particular future period may decrease. In the future, operating results may fall below the expectations of our investors. In that event, the price of our common stock would likely be impacted.

Liquidity and Capital Resources

Currently, our primary capital requirements are for new restaurant development and remodeling of existing restaurants. Similar to many restaurant companies, we utilize operating lease arrangements for all of our restaurant locations. We believe that our operating lease arrangements provide appropriate leverage for our capital structure in a financially efficient manner. We are typically required to expend cash for leasehold improvements, furniture, fixtures and equipment to construct and equip each restaurant. We also require capital resources to maintain our existing base of restaurants, including remodeling, and to further expand and strengthen the capabilities of our corporate and information technology infrastructures.

The following tables set forth, as of the dates and for the periods indicated, a summary of our key liquidity measurements (amounts in thousands):

| | June 30, 2014 | December 31, 2013 |
|---------------------------------|------------------------------|----------------------------------|
| Cash and short-term investments | \$42,198 | \$ 6,058 |
| Net working capital (deficit) | \$34,486 | \$ (6,476) |

| | Six Months Ended June 30, 2014 | | 2013 |
|---------------------------------------|---|---------|-------------|
| Cash provided by operating activities | \$8,064 | \$4,086 | |
| Capital expenditures | \$9,536 | \$1,262 | |

Future Capital Requirements

Our capital requirements, including development costs related to the opening of new restaurants, have historically been significant. Over the past year, we funded development of new restaurants and remodels primarily from cash flows from operations and borrowings under our credit agreement. Our future cash requirements and the adequacy of available funds will depend on many factors, including the operating performance of our current restaurants, the pace of expansion and remodels, real estate markets, site locations, the nature of the arrangements negotiated with landlords and the capital market accessibility.

Our goal is to grow organically through unit expansion, with a goal of 20% unit growth annually over the next several years. We opened the Fort Worth and El Paso, Texas restaurants in February and June of 2014, respectively. We plan to open three additional restaurants during the fourth quarter of 2014. This equates to a unit growth rate of 20% for 2014. We currently have four additional signed leases for new restaurant openings and are working diligently to build our pipeline for future growth.

On June 25, 2014, we completed a public offering of 2.6 million shares of our common stock at an offering price of \$18.50 per share. We sold an aggregate of 2.3 million, of which 0.3 million shares were sold pursuant to the underwriters' exercise of their option to purchase additional shares. The remaining 0.3 million shares were sold by certain selling stockholders. The aggregate net proceeds received for the offering totaled \$40.9 million, reflecting gross proceeds of \$43.4 million, less underwriting expenses of \$2.2 million and other offering costs of \$0.3 million. Net proceeds from the offering will be used for new unit expansion, capital expenditures and general corporate purposes.

As of June 30, 2014, we had working capital of \$34.5 million and no borrowings under the credit facility. We believe existing cash and short-term investments of \$42.2 million, the ability to draw on our \$20.0 million credit facility and cash flow from operations will be sufficient to fund property additions for new restaurants and planned remodels of existing restaurants over the next several years.

Any reduction of our cash flow from operations or an inability to draw on our credit facility may cause a delay or cancellation of future restaurant development or remodels of existing restaurants. Financing to construct new restaurants or remodels for amounts in excess of our current cash and short-term investments and the line of credit availability may not be available on acceptable terms, or at all, and our failure to raise capital when needed could impact our growth plans, financial condition, and results of operations. Additional equity financing may result in dilution to current stockholders and debt financing, if available, may involve significant cash payment obligations or financial covenants and ratios that may restrict our ability to operate our business.

Debt and Credit Agreements

On April 19, 2013, we entered into a Credit Agreement for a \$20 million revolving line of credit (the “Credit Facility”) with KeyBank National Association (“KeyBank”) and Stearns Bank National Association (“Stearns Bank” collectively with Key Bank, the “Lenders”). The Credit Facility replaced the prior \$6.5 million credit line with Stearns Bank (the “Credit Line”). The Credit Facility is secured by our personal property and assets. Certain of our wholly owned subsidiaries have also guaranteed the Credit Facility.

The Credit Facility matures on April 19, 2017, with an option to extend the maturity date for one year subject to the Lenders’ consent. The interest rate on the Credit Facility is calculated at KeyBank’s prime rate or LIBOR, at our option, plus an applicable margin depending on our leverage ratio. The LIBOR margins range from 3.0% to 3.5% and the base rate margins range from 2.0% to 2.5%. Payments on the Credit Facility are interest only, payable quarterly with respect to each base rate loan and at varying times with respect to LIBOR rate loans, with outstanding principal and interest due at maturity. Prepayment is permitted at any time without penalty, subject to certain restrictions on the order of repayment or prepayment. We are obligated to pay a commitment fee, payable quarterly in arrears at an annual rate of 0.375% or 0.50% times the unused total revolving commitment of the Credit Facility, based on the average daily amount outstanding under the Credit Facility for the previous quarter. We recognized commitment fees of \$21,000 and \$41,000 in interest expense during the three and six months ended June 30, 2014.

During the fourth quarter of 2013, we borrowed \$3.5 million against the Credit Facility at the one-month LIBOR rate. The average borrowing rate for the six months ended June 30, 2014 was approximately 3.4%, including the LIBOR margin. On June 30, 2014, we paid off all outstanding borrowings under the Credit Facility with existing cash on hand.

The Credit Facility also requires us to comply with certain covenants, including (a) a minimum fixed charge coverage ratio of 1.25 through March 31, 2015 and 1.50 from April 1, 2015 through the maturity date, and (b) a maximum leverage ratio of 4:1. As of December 31, 2013, there was a technical event of default related to the matter described in Note 10 and accordingly, all borrowings under the Credit Facility were classified as a current liability at December 31, 2013. The default judgment was subsequently set aside on April 7, 2014, and we were in compliance with all covenants at June 30, 2014.

Prior to closing on the Credit Facility, we had loan agreements with Stearns Bank for a \$0.5 million Term Loan and a \$6.5 million Credit Line. We did not have any borrowings under the Stearns Bank Credit Line prior to its termination in April 2013. We utilized existing cash to pay off the outstanding balance on the Stearns Bank Term Loan on April 19, 2013 and wrote off \$66,000 in deferred financing costs related to the prior loan agreements during the second quarter of 2013.

Fees incurred for the KeyBank Credit Facility totaled \$356,000. Unamortized fees of \$295,000 at June 30, 2014 are amortized over the life of the Credit Facility and included in other assets in the consolidated balance sheet. Loan fee amortization during the three months ended June 30, 2014 and 2013 was \$26,000 and \$22,000, respectively, and \$53,000 and \$26,000 during the six months ended June 30, 2014 and 2013, respectively.

Cash Flows

The following table summarizes our primary sources and uses of cash during the periods presented (in thousands).

| | Six Months Ended June 30, | |
|---|----------------------------------|-------------|
| | 2014 | 2013 |
| Net cash provided by (used in): | | |
| Operating activities | \$ 8,064 | \$ 4,086 |
| Investing activities | (9,576) | (1,255) |
| Financing activities | 37,651 | (658) |
| Net increase in cash and cash equivalents | \$ 36,139 | \$ 2,173 |

Operating Activities. Our cash flows from operating activities provided \$8.1 million and \$4.1 million of net cash during the first half of 2014 and 2013, respectively. The net increase in cash from operating activities year over year is primarily due to the lower use of cash to pay for accrued expenses and receipt of tenant allowance reimbursements in the first half of 2014.

Investing Activities. Capital expenditures for the six months ended June 30, 2014 were \$9.5 million, primarily associated with our Fort Worth and El Paso restaurants opened during the first half of 2014 and architecture, design and construction-related costs associated with our other planned new restaurants for the remainder of 2014. Capital expenditures for the six months ended June 30, 2013 were \$1.3 million, primarily associated with maintenance capital expenditures for our existing restaurants and architecture and design costs associated with restaurants added later in 2013.

Financing Activities. Net cash provided by financing activities during the first half of 2014 was \$37.7 million and consisted primarily of \$41.1 million in proceeds, net of issuance costs, from our equity offering, and \$0.1 million from employee stock option exercises. This increase in cash was partially offset by our repayment of \$3.5 million of borrowings under the Credit Facility. Net cash used in financing activities during the first half of 2013 totaled \$0.7 million, consisting mainly of \$0.4 million debt repayment, \$0.4 million in fees incurred for our credit facility and \$0.2 million for the purchase and retirement of our common stock under the May 2012 authorization, partially offsetting \$0.2 million in proceeds from employee stock option exercises and employee stock plan purchases.

Off-Balance Sheet Arrangements

As of June 30, 2014, we had no off-balance sheet arrangements or obligations.

Critical Accounting Policies and Estimates

Critical accounting policies and estimates are those that we believe are both significant and that require us to make difficult, subjective or complex judgments, often because we need to estimate the effect of inherently uncertain matters. We base our estimates and judgments on historical experiences and various other factors that we believe to be appropriate under the circumstances. Actual results may differ from these estimates, and we might obtain different estimates if we used different assumptions or conditions. We had no significant changes in our critical accounting policies and estimates since our last annual report. Our critical accounting policies and estimates are identified and described in our annual report on Form 10-K for the year ended December 31, 2013.

Item 3. *Quantitative and Qualitative Disclosures About Market Risk*

Commodity Price Risk

Our primary market risk exposure is commodity costs. Many of the food products purchased by us can be subject to volatility due to changes in weather, production, availability, seasonality, international demand, and other factors outside our control. Substantially all of our food and supplies are available from several sources, which help to diversify our overall commodity cost risk. We also believe that we have the ability to increase certain menu prices in response to food commodity price increases.

Inflation

The primary inflationary factors affecting our operations are food, labor costs, energy costs and labor and materials used in the construction of new restaurants. Increases in minimum wages could directly affect our labor costs. Many of our leases require us to pay taxes, maintenance, repairs, insurance, and utilities, all of which are generally subject to inflationary adjustments. These increases could impact our operating results to the extent that such increases cannot be passed along through higher menu prices. Over the past five years, inflation has not significantly affected our operating results.

Interest Rate Risk

We may also face market risk exposure due to the variable interest rates on the credit line obtained from KeyBank. Interest on the loans is subject to adjustment based on changes to the LIBOR rate. Interest rate fluctuations may adversely impact our financial condition or results of operations.

Item 4. *Controls and Procedures*

Evaluation of Disclosure Controls and Procedures

Disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) are our controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. We have evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective.

We have not engaged an independent registered accounting firm to perform an attestation report regarding our internal control over financial reporting as of any balance sheet date or for any period reported in our financial statements. Presently, we are not an accelerated filer, as such term is defined by Rule 12b-2 of the Exchange Act. We will be an

accelerated filer as of the filing date of our Annual Report on Form 10-K for the year ending December 31, 2014 because our public float exceeded \$75 million as of June 30, 2014. Our independent registered accounting firm will first be required to attest to the effectiveness of our internal control over financial reporting for our Annual Report on Form 10-K for the year ending December 31, 2014.

Changes in Internal Control over Financial Reporting

During the quarterly period covered by this report, there have not been any changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

We are engaged in various legal actions, which arise in the ordinary course of our business. Although there can be no assurance as to the ultimate disposition of these matters, it is the opinion of our management, based upon the information available at this time, that the expected outcome of these matters, individually or in the aggregate, will not have a material adverse effect on the results of operations or financial condition of the company.

On February 10, 2014, Kona Grill Macadamia, Inc., a wholly-owned subsidiary of the Company (“Macadamia”), filed a Motion to Set Aside Default Judgment in the Circuit Court of Jackson County, Kansas City Missouri relating to a default judgment of approximately \$3.5 million entered into on December 18, 2013 against Macadamia. The underlying personal injury claim, Frank Neal Goss vs. Kona Macadamia, Inc. and Anthony Deangelo, revolves around a fight that two alleged restaurant patrons had outside of the Company’s Kansas City restaurant on March 1, 2011, which is claimed to have resulted in physical injury to the plaintiff.

Following a hearing held on April 3, 2014, the Circuit Court issued a written order on April 7, 2014 granting Macadamia’s Motion to Set Aside Default Judgment. The underlying personal injury case will proceed in the Circuit Court, and on April 16, 2014, Macadamia filed its answer to the plaintiff’s complaint. We believe that we have a strong defense to the claim asserted by the plaintiff and insurance coverage for the claim.

Item 1A. Risk Factors

Except for the risk factor noted below, there have been no material changes in our risk factors since our annual report on Form 10-K for the year ended December 31, 2013. A description of the risk factors associated with our business is contained in Part I, Item 1A, “Risk Factors,” in our Annual Report on Form 10-K for the year ended December 31, 2013. These cautionary statements are to be used as a reference in connection with any forward-looking statements. The factors, risks, and uncertainties identified in these cautionary statements are in addition to those contained in any other cautionary statements, written or oral, which may be made or otherwise addressed in connection with a forward-looking statement or contained in any of our subsequent filings with the SEC.

We will no longer qualify as a smaller reporting company and will be considered an accelerated filer as of the end of fiscal 2014, and as a result, we will have to comply with increased disclosure and governance requirements.

Based on our current public float (market value of securities held by non-affiliates) as of June 30, 2014, we will no longer qualify as a “smaller reporting company” and will be classified as an "accelerated filer" as of the end of 2014. As a smaller reporting company and a non-accelerated filer, we have been able to take advantage of certain exemptions from various reporting and governance requirements that are applicable to other public companies, including not being required to comply with the auditor attestation requirements of Section 404 of the Sarbanes-Oxley Act.

As an accelerated filer and a company that is no longer considered a smaller reporting company, we will be subject to higher professional expenses due to the auditor attestation requirements for SOX 404 compliance, which will adversely affect our net income. Further, we cannot predict if investors will find our common stock less attractive because we can no longer rely on these exemptions which may result in additional costs of compliance. If some investors find our common stock less attractive as a result, there may be a less active trading market for our common stock and our stock price may be more volatile. There are no assurances that investors will find our common stock more attractive, or that there will be a more active trading market for our common stock or that our stock price will be less volatile, when we are considered an accelerated filer.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Not applicable.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

| <u>Exhibit Number</u> | <u>Exhibit</u> |
|------------------------------|---|
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended. |
| 31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended. |
| 32.1 | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101 | Interactive data files pursuant to Rule 405 of Regulation S-T (i) the Condensed Consolidated Balance Sheets as of June 30, 2014 and December 31, 2013, (ii) the Unaudited Condensed Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2014 and 2013, (iii) the Unaudited Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2014 and 2013 and (iv) the notes to the Unaudited Condensed Consolidated Financial Statements. |

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

KONA GRILL, INC.

By: /s/ Berke Bakay
Berke Bakay
*President, Chief Executive Officer
and Director*

(Principal Executive Officer)

By: /s/ Christi Hing
Christi Hing

Chief Financial Officer

*(Principal Accounting and Financial
Officer)*

Date: August 4, 2014